Most of the decisions you make as a small business operator affect your bottom line. Oftentimes decisions made up front have a bearing on your profitability down the road. And oftentimes tax rules and regulations play a role in the outcome. Had you known up front what the tax consequences would be, you may have made a different decision. That's why we put this pamphlet together. It won't give you all the answers, but it will give you food for thought as you organize. In this publication we briefly discuss tax consequences based on forms of ownership, types of record keeping, accounting methods, and estimate tax payment requirements.

Forms of Ownership

Although there are many forms of business ownership, here is an overview of the most common: sole proprietorship, partnership, C corporation, S corporation and limited liability companies.

Sole Proprietorship – This is the simplest form of doing business. It has no existence apart from its owner. A sole proprietor is not considered an employee of the business.

Filing guidelines

- Report your business income and expenses on your personal income tax return (Form 540) using Schedule C.
- The return due date is normally April 15 for calendar year taxpayers.
- The tax rate depends on the proprietor's total income.

Partnership – A partnership must have two or more persons carrying on a business for profit. The business is not taxed as a separate taxed entity. It is a conduit where the profit or loss flows through to the partners. The partners report their shares of the partnership profit or loss on their income or franchise tax returns.

Filing guidelines

- Every partnership that engages in a trade or business in California or has income from California sources and every limited partnership registered with the California Secretary of State, files Form 565.
- The partnership provides each partner with a Schedule K-1 that states the partner's allocation of tax items.
- The return due date is the 15th day of the fourth month after the close of the taxable year.

C Corporation – A C corporation is a separate legal entity owned by shareholders.
C corporations are taxed annually on their earnings and the corporate shareholders are taxed on these earnings when distributed as dividends.

Filing guidelines

- Corporations organized in California, registered in California, doing business in California or receiving California source income file Form 100.
- The return due date is the 15th day of the third month after the close of the taxable year.

S Corporation – An S corporation is a hybrid business entity. It is a separate legal entity and generally offers liability protection to its owners (shareholders). It pays California tax on its net income and also is a conduit through which profit or loss flows to the shareholders. The corporation must elect to be treated as an S corporation. There can be no more than 75 shareholders and only one class of stock. Only individuals, estates, or certain trusts can be shareholders. S corporations can own subsidiaries.

Filing guidelines

- S corporations organized in California, registered in California, doing business in California or receiving California source income file Form 100S.
- The S corporation provides each shareholder with a Schedule K-1 reflecting the shareholder's allocation of tax items.
- The return due date is the 15th day of the third month after the close of the taxable year.

Limited Liability Companies – A limited liability company (LLC) is another hybrid business entity. It is a separate legal entity and generally offers liability protection to its owners (members). Its California tax treatment depends on its classification. If classified as a corporation, it pays tax on its net income. If classified as a corporation, it can elect to be an S corporation. It may also be classified as a conduit partnership through which profit or loss flows to the owners (members). An LLC owned by one person that does not elect to be taxed as a corporation will be disregarded. The profit or loss of an LLC that is disregarded may be reported on the tax return filed by its sole owner.

Filing guidelines

- LLCs that are not taxable as corporations (i.e., classified as partnerships or disregarded) organized in California, registered in California, or doing business in California file Form 568.

Note: Extensions for filing your tax returns may be available. Review the rules for extensions in the booklet for the type of tax return being filed (i.e., individual, partnership, S corporation or C corporation).

Types of Record Keeping

Some general rules about your records:

- Keep a copy of every tax form you file.
- Keep separate bank accounts for business and personal purposes.
- Keep personal expenses separate from business expenses.
- Keep all business records at least four years after the return is filed, and longer in certain circumstances.

Business Expenses – You may not deduct an expense unless state law allows it. To be deductible for state tax purposes, an expense must be "an ordinary and necessary business expense." It is ordinary if it is routinely incurred and accepted in the particular business activity. It is necessary if it is appropriate and helpful to the business. Certain items that you buy cannot be deducted in a single year. You must depreciate them over a period of years.

Common business expenses, subject to state limitations, include start-up costs, meals and entertainment, cars and mileage, one half of social security self-employment tax, health insurance costs, and home office expenses.

Accounting Methods

Businesses generally elect to record income and expenses using either the cash or accrual method of accounting, though other hybrid methods are available.

Cash method

- Income is recorded when received.
- Expenses are deducted when paid.
- Neither accounts receivable nor payable are considered for tax purposes.
- Capital expenditures must be expensed over a period of years.

Accrual method

- Income is recorded when the purchaser becomes obligated to pay.
- Expenses are deductible when the business is obligated to pay.
- Accounts receivable and accounts payable are considered for tax purposes.
- Capital expenditures must be expensed over a period of years.

Over time, one method is not advantageous over the other. However, your trade or business may require the use of a particular method. You must get permission from the IRS and from us before you change methods.

Entity Tax

An entity tax may apply. Here is an overview.

Sole Proprietorship
No entity tax.

Partnership (General)
No entity tax.

Limited Partnership
$800 tax paid annually.

C Corporation
8.84% tax on C corporation income, with $800 minimum.

S Corporation
1.5% tax on S corporation income, with $800 minimum.

Limited Liability Company
If classified as a corporation see appropriate corporation rule. If not classified as a corporation (i.e., classified as a partnership or a disregarded entity) it is subject to an $800 annual tax plus a fee based on total income. (Disregarded entity is defined as an entity that has a single member that has not elected to be taxed as a corporation for tax purposes.)

Estimated Tax

Certain taxpayers are required to make quarterly payments on their estimated tax liability. Here is an overview.

Individuals *(due dates 4/15, 6/15, 9/15, 1/15)*

- Estimate payments required unless
  - 80% of prior year tax is paid by withholding.
  - 80% of current year income is from jobs that had payroll withholding.
  - Prior year tax was less than $200.
  - Current year tax will be less than $200.
- Use Form 540-ES.

Partnerships / Limited Partnerships / Limited Liability Companies (not classified as a Corporation)

- No estimated tax.

Corporations/S Corporations (including LLCs classified as corporation) *(due dates 4/15, 6/15, 9/15, 12/15)*

- Use Form 100-ES.
- See Instructions for Form 100-ES.
- A qualified new corporation may pay a reduced minimum tax for the second taxable year of $500.

The minimum tax is due the first quarterly due date after the corporation is formed.

If you form a qualified new corporation on or after January 1, 2000, there is generally no minimum franchise tax for the first and second taxable years.

If you formed your corporation during calendar year 1999, you must prepay a $300 first year tax to the Secretary of State, and your minimum tax for the second taxable year is $500 payable to Franchise Tax Board.

If you formed your corporation before 1999, your commencing tax is $800 and your minimum annual franchise tax is also $800 for the following years.

FTB Forms Related to Small Business Topics

Form 100	Corporation Tax Booklet
Form 100S	S Corporation Tax Booklet
Form 565	Partnership Tax Booklet
Form 568	Limited Liabilities Companies Booklet
FTB Pub. 1038	Guide for Corporations Dissolving, Surrendering (Withdrawing) or Merging
FTB Pub. 1060	Guide for Corporations Starting Business in California
FTB Pub. 927	Exempt Organizations

Internet Access

The above publications are available on FTB's website at **www.ftb.ca.gov**.

The Small Business Assistance Center, a partnership of California tax agencies and IRS, contains links to various government and private sector sites that provide a wide array of information on the different aspects of starting, running and closing a business in California. It's at **www.taxes.ca.gov/small_business**.

The Small Business Tax Connection, a similar partnership, includes *Striking Gold in California* an easy-to-read booklet with income, sales and employment tax information. You'll find it at **www.boe.ca.gov/sbtcon.htm**.

Toll Free Telephone Access

Public Information . . . . (800) 852-5711
Automated Telephone
Service - 24 hrs. . . . . (800) 338-0505

Assistance for persons with disabilities: We comply with the Americans with Disabilities Act. Persons with hearing or speech impairments, call: from voice phone (800) 735-2922 or from TTY/TDD (800) 822-6268.

Small Business Fax Line

Fax questions about your income tax filing requirements to: (916) 845-5047.

FTB 1123 (NEW 03-2000)

California Franchise Tax Board

State Income Taxes & Small Business